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November 19, 2021

Secretary Janet Yellen
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Yellen:

I write to you on behalf of the Texas Permanent School Fund (the “PSF”) to ask that Treasury exercise its authority to provide a limited exemption from the arbitrage rules under Internal Revenue Code section 148. As you likely know, the PSF facilitates the financing of school construction in my State, affording more efficient use of every taxpayer dollar to the benefit of Texas’ children. The Texas Education Agency (“TEA”) projects that absent another round of regulatory relief, the arbitrage rules will impair the ability of the State of Texas to fund new school projects where planning is already underway for the next two to three years, creating the need for prompt relief.

The PSF was created in 1845 for the benefit of Texas public schools. In 1876, the Constitution of Texas contributed certain lands and all proceeds from the sale of these lands to the PSF. Subsequent acts contributed more public domain land and rights to the PSF, including mineral-related bonuses, rentals and royalty payments with respect to such lands. The PSF has grown considerably over the years and is now comprised of diverse assets.

The Bond Guarantee Program under the PSF was created in 1983 to support Texas K-12 school construction. Under the Bond Guarantee Program, the PSF guarantees municipal bonds issued by or on behalf of Texas Schools, thus enhancing the credit rating of these bonds as described below. As with any financial instrument, enhancement of credit rating ultimately imparts more efficient use of funds appropriated for education as it results in fewer dollars spent on interest cost, thereby ensuring more dollars are spent on actual education needs. This program is designed for schools with underlying credit ratings lower than “AAA”, or the equivalent, by one or more of the accepted municipal credit rating agencies (the “Rating Agencies”), since schools with lower credit ratings face higher net interest cost (“NIC”) for their financings.

An alternative in the municipal marketplace to lower the NIC of a bond issue generally is to purchase a letter of credit or municipal bond insurance policy providing additional credit support to the bond issue. However, the best option available to Texas schools is to add to its bond issue a guarantee from the PSF, thereby raising the credit rating of the guaranteed bonds. ***With its “AAA” rating, the Bond Guarantee Program of the PSF is actually a stronger guarantor than***

any of the letter of credit or municipal bond insurance products^[1] currently available in the municipal marketplace. Thus, the Bond Guarantee Program provides substantial support to Texas Schools that meet certain debt service limits and financial stability requirements by being a more cost-effective solution than any other in the marketplace.

The “arbitrage” restrictions under Section 148 stem from the concern, first originating in the 1980s, that states and local governments could borrow at low tax-exempt interest rates and invest the proceeds of the borrowing at higher taxable interest rates, thus earning “arbitrage” upon which they do not owe any tax liability. Over time, this principle has been expanded since its first introduction to include not only the direct proceeds of a municipal bond issue but also amounts expected to repay the bond issue or pledged to guarantee the bond issue. This latter pledge concept is what pulls the PSF into the purview of these rules since the Bond Guarantee Program places guarantees on tax-exempt bond issues. Without an exception to these rules applicable to the PSF, the “arbitrage” Regulations under Section 148 of the Code would limit the permissible investment yield on the PSF to the tax-exempt yields of the guaranteed bonds, substantially reducing the ability of the PSF to perform its mission of supporting Texas K-12 education.

In order to avoid this adverse impact, since the 1980s and the inception of the “arbitrage” rules, the PSF has worked with the Internal Revenue Service (the “IRS”) and Treasury to obtain limited exemptions from these restrictions. This relief has varied in form over time, but has included, in addition to the current regulation under Section 1.148-11(d) (the “Current Regulations”), private letter rulings and notices. Until the release of Notice 2010-5 by the IRS in 2009, the exemption of the PSF program from the “arbitrage” restrictions continued only so long as the dollar amount of the guaranteed bonds did not exceed 2.5x the lower of cost or fair market value of the PSF’s assets, excluding additions to the PSF made since May 14, 1989 (the “Pre-2009 Limit”). ***During 2009, the Bond Guarantee Program reached capacity under the Pre-2009 Limit; as a result, the Bond Guarantee Program was closed to new applications for guarantees until relief was obtained from the IRS.*** This closure imposed a hardship on Texas K-12 Schools by increasing their cost of funds. On December 16, 2009, the IRS published the aforementioned notice, which stated that the IRS would release proposed regulations amending the Pre-2009 Limit to 5x the total cost of the assets held by the PSF on that date. The Current Regulations were promulgated after considerable delay on July 18, 2016, during which interval the PSF was able to operate the Bond Guarantee Program under the terms of the Notice.

The PSF has formulated a number of regulatory options that would provide the relief needed from the arbitrage rules, and given the population growth in Texas, especially among school age children, the need for new school construction is substantial.

I am requesting that you advise me of the appropriate technical experts at Treasury and when they can be available to meet during December with TEA representatives and my office to discuss these options. Hopefully, a constructive discussion will permit you Treasury to issue a limited exemption to the arbitrage rules to enable the most cost effective response to the needs of

^[1] Assured Guaranty Municipal and Build America Mutual, the two market leaders, are each rated “AA”, so less than the PSF’s “AAA” rating.

Texas' growing school population. Please contact me personally or Mark Rickling who assists me with tax matters before the Ways and Means Committee.

Sincerely,

A handwritten signature in black ink, appearing to read "Lloyd Doggett". The signature is fluid and cursive, with a long horizontal stroke extending from the end.

Rep. Lloyd Doggett